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TAGS: [ECON](#) [EINV](#) [ENRG](#) [RS](#)
SUBJECT: ELECTRICITY SECTOR REFORM: INVESTMENT BROWNOUT?

Classified By: Economic Minister Counselor Eric T. Schultz for reasons
1.4 (b, d)

Summary

11. (C) A mere three months after RAO UES completed its privatization program, efforts to bring Russia's electricity sector into the post-Soviet period are being crippled by a lack of investment financing, sagging industrial demand, and a new "energy" team that includes state-centrists, such as Deputy PM Igor Sechin and Energy Minister Sergei Shmatko. With an economic downturn gathering speed, generating companies are seeking to reduce their investment obligations and prospective foreign investors are deciding to avoid the market. The silver lining in this, if there is one, is that worries about breakneck economic growth straining the electricity system can now be put aside. End summary.

No Funding for Grid Improvements

12. (C) Chairman of the Federal Grid Company Andrei Rappoport told us candidly that all plans to update or expand Russia's electricity grid were on hold indefinitely. The Federal Grid Company does not expect to receive any federal budget support for the near future. Demand from enterprises seeking increased capacity had all but disappeared. Other sources of income will cover about 30 percent of the grid's financial needs, which will only be sufficient to fulfill maintenance programs.

Back to the Future?

13. (C) Rappoport made no bones about his dislike for Igor Sechin, who was nominated to the Board of Inter RAO on October 6, and Energy Minister Shmatko. Rappoport (a disciple of Chubais) was critical of what he perceived as their state-centered philosophy, leading to efforts to assert a more active state role in the electricity sector. Sechin and Shmatko would seek to roll back the reforms that Chubais had achieved in the electricity sector, Rappoport claimed. While it was impossible now to "undo" the RAO UES privatization, recent decisions not to complete the privatization of OGC-1 and Inter RAO, two generating companies, did not augur well. (Note: The GOR's decision to hold on to OGC-1 may have resulted from the fact that the major prospective investor, Dubai World, backed out of the deal. And since Inter RAO focuses on international and

strategic investments, it is not an area that the GOR is likely to let into private hands in any event. End note.) Rappoport predicted that Sechin and Shamtoko would give preferential treatment to investors with close ties to the Kremlin, and that the lack of transparency and non-discriminatory access to the grid would tend to discourage participation of serious strategic investors in the sector. As Rappoport put it: Russia cannot sustain a "half-deregulated" electricity sector.

Generating Companies' Commitments Too Expensive

14. (C) Purchasers of electricity sector assets are now finding that the investment plans to which they agreed have become too expensive. According to UBS analyst Igor Goncharev, the combination of Russia's falling industrial production, tight credit, and expensive infrastructure development inputs will pressure investors to renegotiate their obligations. On October 7, Energy Minister Shmatko reportedly advised that, given the current difficult environment, the Energy Ministry was preparing to review the implementation of generating companies' investment programs.

15. (C) Foreign investors are already pulling out of the Russian electricity market. The week prior to Shmatko's announcement, both RWE, a German power concern, and Dubai World (as noted above) had declared separately their decisions to withdraw from agreements to purchase generating companies TKG-2 and OGG-1, respectively. Rappoport confided he was surprised that any investor would have thought the Russian electricity sector could ever be profitable, even before the global financial crisis. He surmised that the foreign investment to date - by German, Italian, and Finnish concerns - was motivated by a desire to establish long-term strategic footholds in the Russian market and had little to do with securing profits over the short term.

At Least the Likelihood of Blackouts is Low

16. (C) With plans for improvement and expansion of the electricity sector on hold, Rappoport told us that the GOR was now focusing on making sure "the lights and heat would stay on this winter". In other words, the GOR was slipping back into a command economy mode: ensuring that gas and coal had been adequately sourced so that popular unrest over rising electricity prices would not be further fueled by power outages. On a brighter note, Rappoport said that, as a result of the recession (he felt Russia was already in one), electricity demand would not grow dramatically. This in turn meant that the electricity sector would be able to improve electricity infrastructure in a measured manner that could keep pace with eventual increases in demand.

Comment

17. (C) Electricity supplies have long been a volatile issue for the GOR, although Russia probably will muddle through another winter. Long term development and expansion of the sector, however, is in question. In all likelihood, Russia will end up with an electricity market that is deregulated in name, but that is operated in a command economy style. Infrastructure improvements will languish and further hamper Russia's ability to get beyond a commodity-based economy. End Comment.
BEYRLE